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Amid market turmoil, Denmark's policy mix proves robust

[The Wall Street Journal](#)

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A highly unusual monetary policy mix introduced by Denmark to defend its fixed exchange rate at the height of the European debt crisis is proving robust amid renewed turbulence on world currency markets, the Nordic state's central bank governor said.

As the exchange rates of a range of currencies from the Brazilian real to the Indian rupee to the Norwegian krone have been volatile in the face of expectations that the [US Federal Reserve](#) will ease back on monetary stimulus, the Danish krone has held its ground.

Denmark's rare move to cut its deposit rate below zero just over a year ago has helped, Nationalbank Governor [Lars Rohde](#) said in a recent interview.

"The good news is that [the negative rate] has had an impact on the currency market," Rohde said. "It has been a very efficient tool to avoid unwarranted capital inflow."

While the central bank of New Zealand — another steady, small economy — has had to sell its currency over recent months to cool appreciation, Nationalbank hasn't intervened in the market since January.

Back in July 2012, with the euro crisis deepening, investors were scrambling to sell euros and buy Danish kroner, seen as less risky because of Denmark's relatively strong public finances. The krone strengthened and Denmark's Nationalbank started cutting interest rates to sap investor enthusiasm for the currency.

"Denmark over this period has been some kind of safe haven with interest rates close to and in some periods below government [bond](#) rates of Germany," Rohde said.

When the deposit rate reached zero, and with the krone still rising, the bank took the plunge and cut it to minus 0.2% before later raising it again to minus 0.1%.

Just over a year on and the euro trades at DKK7.4612 compared with DKK7.4311 then.

That Denmark chose to cut below zero is a sign of how highly it values its euro peg.

"We will do whatever it takes to protect the peg," Rohde said. "The one and only role for Danish monetary policy today is to secure the peg."

The central bank has a stated aim of keeping the euro within 2.25% of a central parity of DKK7.46038. It moves interest rates and buys and sells its own currency to stay within this band.

Since January it has stood pat even though markets have been turbulent recently. That volatility was triggered by a May signal from the US Federal Reserve that it could soon start scaling back its \$85 billion-per-month bond-buying program.

Denmark is unusual in Europe in that it has chosen to bind its currency to the euro without having any immediate plans to join the currency area. Other countries with a similar peg — such as Latvia and Lithuania — are in the process of joining the euro zone.

Having a currency peg offers a level of stability for Denmark's exporters. The central bank's commitment to it helps anchor inflation expectations too, Mr. Rohde said.

"Everyone knows the rules of the game," he said.

A deposit rate below zero means banks have to pay to park deposits above a certain level with the central bank.

This cost drives down the desirability of krone-based assets. Apart from a similar move by Sweden's [Riksbank](#) during the financial crisis applying a negative interest rate is almost unheard of.

Rohde acknowledged the limits of his bank's use of a negative rate, as below a certain level banks and depositors have an incentive to switch into cash rather than carry the cost of central bank deposits.

"We have not come near those limits," Rohde said.

Denmark's Nationalbank says moving the deposit rate below zero hasn't meant large costs for banks. The impact of the negative rate on banks' profitability is about 200 million Danish kroner (\$35 million) a year. The biggest bank, [Danske Bank](#), posted profits of around DKK2 billion in the second quarter

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alone.

These practical lessons of what happens in a sub-zero rate environment will be closely watched by other central banks in case they one day need to do something similar.

The European Central Bank, the Bank of England and the Fed all have rates close to zero to help stimulate struggling economies.

The Danish central bank governor didn't comment on whether he had received calls from colleagues elsewhere asking for advice.

The Danish economy has been slowly recovering after a sharp downturn during the financial crisis which began in 2008. A sharp fall in house prices caused consumers to rein in spending which had a negative knock on effect for government revenues and businesses.

Danish banks also suffered as agricultural and commercial property development projects turned sour.

Rohde said he felt that the banks were probably now "out of the woods" after a series of parliament sponsored support packages. The governor said he sees signs that economic growth is picking up.

It should be "modest but positive" this year and between 1.5% and 2% next year, he said.

Data Friday showed gross domestic product rose 0.5% on the quarter in the second three months of the year, helped by an upturn in exports.

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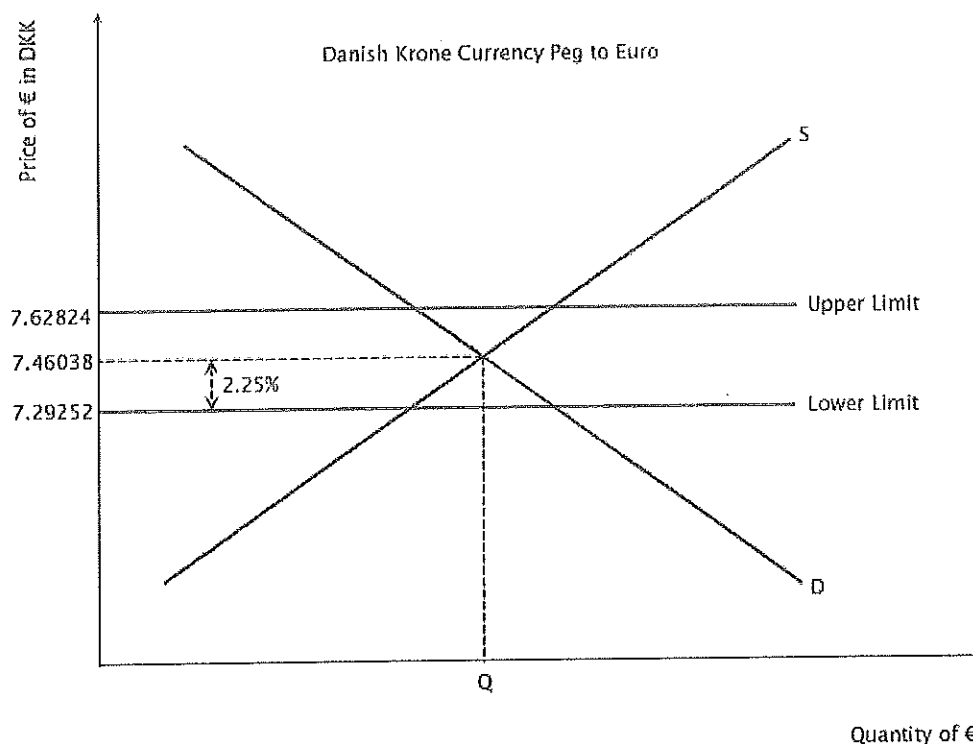
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Denmark's currency, the Krone, is maintained at a fixed exchange rate. This means that the value of the Krone is pegged or fixed to the value of another currency, the Euro. This currency peg that Denmark is keen to secure has been effectively manipulated with an uncommon monetary policy of negative deposit rates. The consequences of the peg will be evaluated further. The diagram below shows how the central bank maintains its currency peg, within "2.25% of a central parity of DKK7.46038".



The primary advantage of a fixed exchange rate is its steadiness. This "offers a level of stability for Denmark's exporters" because European demand (Denmark's main trade partners) will not change abruptly. Currency fluctuations make exports relatively more or less expensive, but pegging the Krone to the euro allows European importers to purchase Danish exports at the same price regardless of a euro depreciation. This allows Denmark to maintain its decade-long current account surplus as a net exporter of food and energy. Furthermore, there is more stability for the government as commitment to the peg "helps anchor inflation expectations". With a fixed currency, consumers are not worried of sudden changes in currency values that can spiral inflation, helping the government maintain its macroeconomic objective of a stable inflation rate.

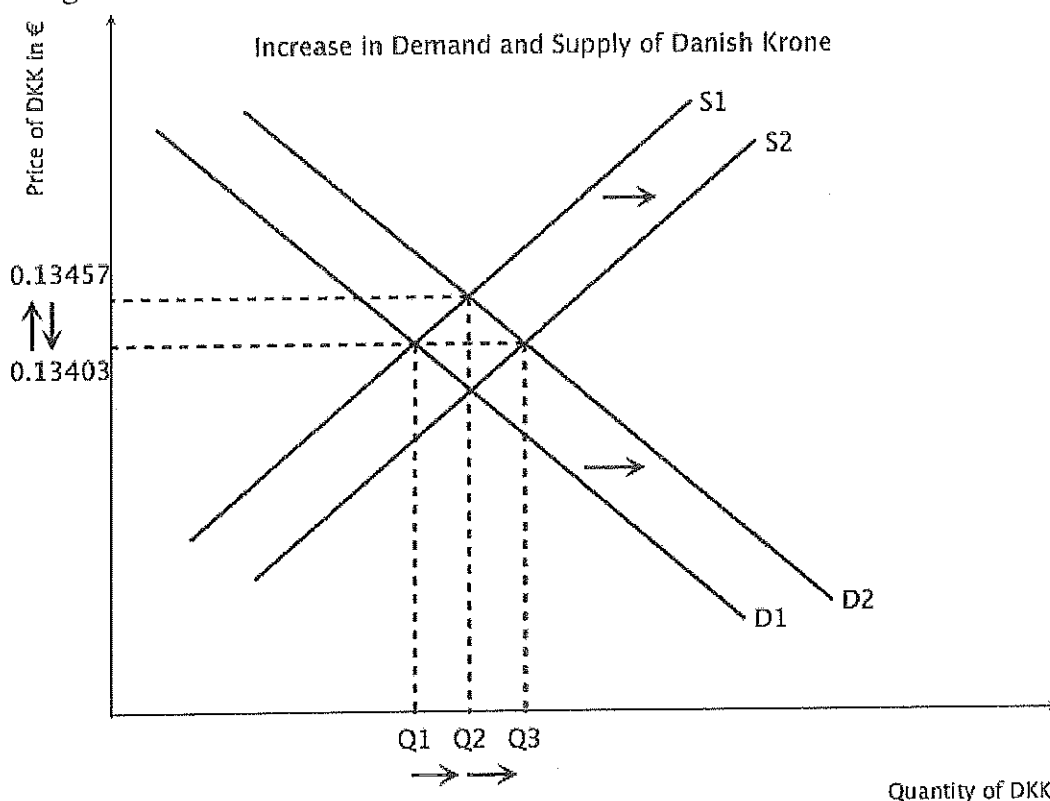
Demand for the Krone has been strong as "investors were scrambling to sell euros and buy Danish kroner" in 2012 when the euro crisis worsened. The Krone is viewed as a stable alternative currency for investment in the region over the euro "because of Denmark's relatively strong public finances". Demand for the Krone rose, shown in the outward shift from D_1 to D_2 below, which would appreciate the currency in a floating exchange rate. This causes price to increase, and quantity of kroner demanded to increase from Q_1 to Q_2 .

However, Denmark's central bank, Nationalbank, wishes to maintain a currency peg. Intervention in the foreign exchange market is required to reduce demand. Nationalbank chose to implement negative deposit rates to curb demand. Deposit rate is the interest rate paid by institutions to owners on their cash deposits. Negative domestic deposit rates "sap

investor enthusiasm for the currency” since deposit owners would have to pay Danish institutions a fee to deposit their cash there, instead of receiving interest on their deposits conventionally. Financial investment abroad becomes relatively more attractive, so investors exchange the Krone for foreign currencies to invest or save their money abroad. This increases the supply of kroner on the foreign exchange market from S_1 to S_2 , lowering the Krone’s exchange rate, reducing its price while quantity increases from Q_2 to Q_3 .

Price increases then decreases between €0.13403 and €0.13457 to 1 DKK, as shown in the text of the final Krone depreciation that “the euro trades at DKK7.4612 compared with DKK7.4311 then” as a result of the central bank intervention.

As Nationalbank Governor Lars Rohde said, “the one and only role for Danish monetary policy today is to secure the peg”. However, monetary policy, defined as the established policies controlling the supply of money and level of interest rates in an economy, has other economic uses that can no longer be utilized. Interest rates typically control the cost of borrowing that has a direct effect on Investment, a component of Aggregate Demand (AD).



For example, if the economy experiences a boom, the central bank can increase interest rates which increases the cost of borrowing. This discourages firms from capital investment, as it is more expensive to repay loans. Nationalbank loses control over its impact on AD when it manipulates monetary policy solely for the peg.

An alternative to manipulate the exchange rate is to buy foreign currencies. Since the government wishes to lower the value of the Krone, it can buy foreign currencies on the foreign exchange market by selling its own currency. This increases the government’s foreign currency reserve, and the supply of kroner on the foreign exchange market.

Its disadvantage is that large reserves of foreign currencies must be held to effectively manipulate the demand and supply of the domestic currency. Furthermore, the current

scheme has proven effective for the Danish economy. Unlike New Zealand that requires constant intervention using foreign reserves, "Nationalbank hasn't intervened in the market since January." Negative deposit rates have cost banks a minimal loss of "200 million Danish kroner (\$35 million) a year". Rohde statement that "it has been a very efficient tool to avoid unwarranted capital inflow" sums up the effectiveness of the monetary policy in the Danish economy.